

**Testimony
of Henry J. Aaron¹**

**Before the Senate Finance Committee
7 March 2001**

Mr. Chairman:

Thank you for the invitation to testify this morning before your committee on proposed legislation to lower personal income tax rates. My testimony will be framed as answers to five questions that I believe are central to appraisal of this proposal. I pose the questions, answer them briefly, and then amplify on those answers below.

Question 1 **Is \$1.6 trillion a reasonable estimate of the cost of the tax cuts now under consideration?**

Answer: No. If all elements of President Bush's proposal are enacted, the cost is likely to be at least \$2.5 trillion. To begin with, the direct cost of the cuts he has asked for is actually above \$1.6 trillion, based on Joint Tax Committee estimates. Furthermore, the full cost of the plan includes added interest payments and the eventual, but inevitable, adjustments in the alternative minimum tax so that filers will receive promised cuts.

Question 2 **Does the prospective budget situation justify a tax cut of the magnitude proposed by the administration?**

Answer: The budget situation is favorable, but uncertain. While a tax cut of some size may be desirable, H.R. 3, which embodies the Administration's income tax rate reductions, is excessive. Furthermore, this tax cut and the various other announced plans of the Administration and Republican leadership in Congress are jointly inconsistent with future budget balance. Something has to give. You and other members of Congress will have to weigh these competing priorities. But until you have done so through the budget resolution, it is precipitate to move ahead with tax legislation.

Question 3 **Given the pervasive signs of economic weakness, should a tax cut be enacted as part of an anti-recession strategy?**

Answer: The tax reductions proposed by the Administration and embodied in H.R. 3 would have an undetectably small anti-recession effect. They are heavily concentrated in out-years when the nation will be long past any slowdown that may now be occurring. They are focused on income brackets whose members spend relatively little out of each additional dollar of income. More generally, discretionary changes in tax rates almost invariably come at the wrong time, a judgment that is well documented by liberal and conservative economists alike. Furthermore, accommodative monetary policy is necessary if tax cuts are to stimulate demand, and it is sufficient to stimulate demand, even without tax cuts. Tax policy, most economists now agree, should be designed with

¹ Bruce and Virginia MacLaury Senior Fellow, The Brookings Institution. This testimony reflects my own views and does not necessarily represent the opinions of the trustees, officers or other staff of the Brookings Institution.

long-term objectives in mind—specifically, how large the government should be and how much, if at all, the government should contribute to national saving.

Question 4 Is the proposed distribution of tax cuts fair?

Answer: The proposed tax cuts would lower the total tax burdens and increase after-tax incomes most for people in upper-income brackets who have enjoyed disproportionate increases in their before- and after-tax incomes over the past decade. Judgments about fairness are inevitably subjective. You and other elected officials will have to decide whether you want to enact a tax cut that will reinforce the dramatic increase in economic inequality that has occurred in the past quarter century.

Question 5 Is there a better way?

Answer: Yes. The proposed tax cuts squander a rare and precious opportunity to dramatically simplify the U.S. tax system and to reform it to promote economic efficiency. Former House Ways and Means Committee chair, Dan Rostenkowski, recently commented in *The Wall Street Journal*, that tax reform is easiest when rates are cut. Tax cuts ease the pain of those who lose tax breaks repealed to achieve simplicity. If taxes are to be cut as much as the administration proposes, it would be possible to “buy” a lot of reform. The Administration’s proposals contain little reform and in some ways further “complexify” the tax code.

**Is \$1.6 trillion a reasonable estimate of
the cost of the tax cuts now under consideration?**

The presentation of the Bush plan has been marked by inconsistency and incompleteness (see table 1). The description of the plan and illustrations of how those provisions will affect people do not agree with the amount President Bush has committed to reduce taxes. Furthermore, it now appears that the Treasury Department’s estimates of the plan’s cost are somewhat lower than those of the Joint Tax Committee.

If enacted, the Bush plan would subject many taxpayers to the minimum tax. By 2011, if H.R. 3 passes, an estimated 35.7 million filers would be subject to the minimum tax, 15 million more than if that bill is not enacted. Yet the examples used to illustrate the effect of the Bush plan do not point up the fact that those filers would not receive the tax savings promised by the rate reductions. To make sure that the tax cuts promised by H.R. 3 actually flow through to taxpayers would raise the direct cost of the plan by an estimated \$292 billion from 2002 through 2011.

The full budgetary impact of any tax or spending bill includes its effects on interest obligations of the federal government. It is well understood that spending increases or tax cuts cost more than their direct cost because they increase public debt outstanding and the associated interest cost of that debt.

Similarly, spending cuts or tax increases reduce interest payments. Some administration spokespersons have criticized the inclusion of interest costs in estimates of the price of the tax cut plan. It is hard to know how to respond to such remarks. Perhaps those who utter them have not lately run a credit card balance, taken out an auto loan, or negotiated a home mortgage.

The Cost of Tax Cuts Under Active Consideration		
Provision	Cost (billions of dollars)	
	Direct	Interest
<u>Bush Tax Program</u>		
H.R. 3	\$958 ¹	\$ 253 ³
Adjustment of Alternative Minimum Tax (AMT) for rate cuts	292 ¹	50 ³
Remainder of tax plan	809 ²	184 ³
<i>Subtotal</i>	<i>\$2,059</i>	<i>\$487</i>
<i>Total Cost of Bush Program</i>		<i>\$2,546</i>
<u>Additional Tax Initiatives</u>		
Additional marriage penalty relief, repeal telephone excise, raise IRA limits, lower inclusion of Social Security benefits	\$380 ³	\$103 ³
<i>Total Cost: Bush Plan, plus Congressional Initiatives</i>		<i>\$3,029</i>

¹ Source: Joint Committee on Taxation, #01-1 029, 28 February 2001

² *A Blueprint for New Beginnings*, Table S-9.

³ Author's calculations

Table 1 displays the cost of the Bush plan taking these adjustments into account. Table 1 includes the Joint Tax Committee's estimate of the cost of H.R. 3, \$958 billion. This estimate somewhat exceeds that of the Administration as reported in *A Blueprint for New Beginnings*. If one adds the

Administration's estimates of elements of the plan not included in H.R. 3, the direct cost is not \$1.6 trillion, but \$1.77 trillion, ignoring added interest and modifications of the alternative minimum tax.

The bottom line is that the total cost of the Bush plan, with the JTC estimates, correction of the AMT, and interest outlay effects, is not \$1.6 trillion, but a bit over \$2.5 trillion. This figure does not include the cost of various other tax cut initiatives that have enjoyed strong Congressional support. Nor should it, because these cuts are not Administration policy. But prudent legislators cannot ignore that Congress may enact tax legislation in addition to the president's request. There was strong support in Congress last year for various additional tax cuts that may be added in the course of Congressional debate. I am not suggesting that Congress would blithely inflate the size of President Bush's requested tax cuts. But I do believe that the possibility that Congress might pass some of these provisions should cause it to temper the rate cuts it enacts now.

Does the prospective budget situation justify a tax cut of the magnitude proposed by the administration?

The prospective budget surplus over the next ten years is \$3.1 trillion according to the Congressional Budget Office. There is unanimous agreement, I believe, that the separate \$2.5 trillion in reserve build-up in the Social Security trust funds should not be used to finance on-budget spending increases or tax cuts. It would make no sense for a business to declare a dividend because its employees' pension plan had a good year. This reserve build-up—and much more besides—will be required to provide the benefits promised under current law. To be sure, Congress may modify Social Security, but until it does so, these additions to reserves are “spoken for.”

Pension Reserves. If one accepts the logic that additions to Social Security reserves should not justify on-budget spending increases or tax cuts, it is difficult to see how accumulations in the pension reserves held for federal employees should be used for current on-budget spending or tax cuts. Additions to those funds are projected at approximately \$419 billion over ten years (see table 2).

Medicare. Similarly, if one agrees that Social Security reserves should not be used to underwrite tax cuts or spending increases, the same logic applies with equal force to accumulations in the Medicare Hospital Insurance trust fund, projected to run a bit under \$400 billion. This accumulation should not justify tax cuts or on-budget spending increases, because the accumulating reserves—and much more besides—will be necessary to deliver on currently promised Medicare benefits, to say nothing of the additional costs that will be necessary to provide an adequate prescription drug benefit and to implement other reforms that members of both parties agree are desirable.

In *A Blueprint for New Beginnings*, the Administration argues that the Hospital Insurance (HI) surplus should be available to pay for tax cuts or spending increases because the overall Medicare system—HI and Supplemental Medical Insurance (SMI) together—will spend more than provided by payroll taxes and premiums. In a long life of seeing peculiar arguments, I must say that this one

is among the most bizarre. The Administration points to the long-term financing problems of Medicare as one reason for prompt reform of that program, a sentiment that I completely endorse. At the same time, it argues that the admittedly inadequate reserves of the HI fund should be available to underwrite tax cuts or on-budget spending increases. But one cannot have it both ways. A system whose parlous long-term financial state supports prompt reform is not a system whose reserves can be treated as an on-budget piggy-bank.

Table 2 Disposition of the On-Budget Surplus <i>(Trillions of dollars)</i>		
Projected On-budget Surplus		\$3.12
<i>Less already committed funds</i>		
Federal Employees Retirement	.42	
Medicare HI	.39	
<i>Equals Available On-budget Surplus</i>		\$2.31
<i>Less Administration Proposals</i>		
Medicare drug benefit	.15	
Discretionary spending initiatives	.26	
Defense increases and missile defense	(.20)	
Added interest costs	.18	
<i>Equals "Revised Available" On-budget Surplus</i>		\$1.52
<i>Less Additional Spending</i>		
Additional growth of discretionary spending	.26	
Additional interest costs (Discretionary Adds)	.08	
<i>Equals "Plausibly Available" On-budget Surplus</i>		\$1.18

If one subtracts the build-up of federal employee pension reserves and of HI Trust Fund reserves, the remaining on-budget deficit properly available to underwrite tax cuts or spending increases falls to \$2.3 trillion.

New Administration Initiatives. The Administration has also announced that it wishes to commit \$153 billion to a Medicare drug benefit and to Medicare reform. That sum is insufficient to achieve the Administration's stated goals and I believe that Congress will go beyond these amounts if it passes legislation, but it is the Administration's policy. The administration has also called for increases in discretionary spending, other than missile defense and other defense increases that may come after the defense policy review, totaling \$260 billion.

The president has refused to boost defense spending increases (beyond pay raises) until the completion of a thorough defense policy review. That restraint is admirable. But the presentation of a budget that relegates likely increases to a contingency reserve that is largely imaginary is not. I have assumed—arbitrarily I admit—that missile defense and other additions to defense expenditures add \$200 billion over ten years to the defense budget.

Taking account of these items, plus the added interest outlays they will require, the revised available on-budget surplus drops to \$1.5 trillion.

Additional Plausible Discretionary Outlays. The administration also proposes \$230 billion in unspecified discretionary spending cuts. I have not included them in table 2. To begin with I am old enough to remember “Magic Asterisks” and I strongly believe in the old saying: “fool me once, shame on you; fool me twice, shame on me.” In addition, I think all Americans should pay close attention when a highly respected Senate Budget Committee chairman, whose credentials as a conservative are unimpeachable, admonishes the director of the Office and Management and Budget that the Administration's discretionary spending targets are too low. Discretionary spending has actually grown at an annual rate of 5.3 percent from 1998 through 2002 (projected under current policy by CBO). *If discretionary spending growth slows to 4 percent a year over the next decade, which would result in the steady decline of such spending as a share of GDP from 6.3 percent (its current level) to 5.8 percent, it would exceed the Administration's estimate by \$490 billion cumulatively over ten years.* Since I have already excluded the claimed savings, that represents an addition to discretionary spending of \$260 billion. One should also allow for the added interest costs that will result from increased discretionary spending.

The result is a projected surplus of \$1.18 trillion. I believe that the \$1.18 trillion estimate for the budget surplus is still unrealistically high as 4 percent growth in nondefense discretionary spending seems low because it is based on unrealistic assumptions for discretionary spending and provides no allowance for the sorts of budgetary surprises that led a graduate school friend to remark ruefully that “Each month a nonrecurring expense ruins my budget.”

But even this quite generous estimate of available budget surpluses is less than the \$1.6 trillion President Bush has indicated he wishes to apply to tax cuts and more than \$1 trillion less than the more accurate measure of his tax program's cost. *It will not have escaped your notice, I am sure, that these calculations indicate that the so-called "trillion-dollar" contingency reserve does not exist.*

Uncertainty. So far, I have talked as if projections were reliable. Such a belief, as you know better than I, is ridiculous. The extremely talented and dedicated economists and budget forecasters, in government and in the private sector, seldom get budget projections even a few years in the future quite right; often they are not even close. The job is so hard that the phrase "accurate budget forecasting" is an oxymoron. The Congressional Budget Office this year dramatized that point with a splendid graphic on page xviii of *The Budget and Economic Outlook: Fiscal Years 2002-2011*. It shows that as soon as 2004 the range of reasonably plausible outcomes encompasses a possible budget deficit and surpluses as large as 820 billion. By 2006, the difference between the 5th and 95th percentile of the projection range is more than \$1.2 trillion—just for that one year.²

The bulk of the projected budget surpluses are far enough in the future that it would be rash to commit all of them now. *More than three-quarters of the surpluses projected by the Administration and CBO do not occur during the current terms of the incumbent president or 94 percent of the members of Congress.*

No responsibly managed business would commit all of the budget surpluses projected for the next decade. To be sure, future surpluses may be larger than the best current guesses of the CBO and the Administration. I certainly hope they are, so that future Congresses will be able to cut taxes even more than the Administration now requests. I also hope that future events do not put unanticipated demands on our public sector. But we cannot be sure.

**Given the pervasive signs of economic weakness,
should a tax cut be enacted as part of an anti-recession strategy?**

The answer to this question is a short, simple "no." For several decades, conservative economists argued that activist fiscal policy—the attempt to vary public spending or taxes to combat economic fluctuations—was ill-advised. Milton Friedman wrote journal articles showing that even slight mistiming of fiscal interventions would make business cycles worse—even under the assumption that fiscal policy actually affected overall demand, which he doubted. Murray Wiedenbaum showed in his doctoral dissertation that use of defense contracting for countercyclical purposes was counterproductive. Friedman, Jerry Jordan, and others argued, more fundamentally, that fiscal policy that was not supported by monetary policy would have little short-run and no long-run effect

² Congressional Budget Office, *Uncertainties in Projecting Budget Surpluses: A Discussion of Data and Methods*, February 2001, Table 5.

on aggregate demand. And monetary policy on its own, they argued, could provide the needed stimulus to fight all but the deepest and most protracted recessions. I believe that they have largely won that debate. At the same time, so-called automatic stabilizers are vitally important to maintain and strengthen because they soften the effects of economic downturns on vulnerable families and individuals.

For this reason, the argument heard recently from the Administration and some members of Congress from both parties, that tax cuts are a good tool for fighting the sort of slow-down we are now experiencing is simply wrong. But even if it were right, the tax cut embodied in H.R. 3 would have essentially no effect on aggregate demand. In 2001 it would amount to only 5 one-hundredths of 1 percent of GDP. Even if aggregate demand rose by \$2 for each \$1 of tax cut—an implausibly high estimate, since the tax rate cuts would provide disproportionate benefits to families subject to the top rates, whose current consumption purchases are unlikely to be constrained by cash flow—the impact on aggregate demand would be an undetectable one-tenth of one percent of GDP.

In short, there are good reasons for having a debate about tax cuts. The current economic slowdown is not one of them.

Is the proposed distribution of tax cuts fair?

If one believes that income in the United States is too equally distributed and that the sharp increases in inequality over the past two decades are moves in the right direction, the income tax rate reductions in President Bush's tax plan are well designed. If one holds other beliefs, one has reason to question the fairness of the Bush plan which would disproportionately increase the after-tax incomes of the well-to-do (see table 3).

Table 3
Percentage Increase in After-Tax Income
from the Bush Budget Cut

Income Group	Citizens for Tax Justice + Treasury estate tax estimates Bush Plan	Citizens for Tax Justice + Treasury estate tax estimates H.R. 3
Bottom Quintile 0-20 percentile	0.6 %	0.5 %
Second 20 % 21-40 percentile	1.2 %	1.0 %
Middle 20 % 41-60 percentile	1.9 %	1.2 %
Fourth 20 % 61-80 percentile	2.3 %	1.2 %
Next 15 % 81-95 percentile	2.4 %	1.1 %

Next 4 % 96-99 percentile	1.4 %	0.6 %
Top 1 percent	6.2 %	3.8 %

Source: Center for Budget and Policy Priorities, 6 March 2001.

To raise such issues is not, as some Administration spokespersons have alleged, an act of class warfare, but the exercise of responsible discussion in a democracy. Deciding how taxes are distributed is one of the central responsibilities of any legislature. These decisions inevitably are—and should be—political, in the highest sense of the word. To label as class warfare a discussion about the fairness of the Administration's tax cut is to ignore how democracy does and should work.

For let us be clear, most of us would be delighted to pay less tax than we do. The state uses its power to collect taxes because that is the only way in a democracy that we can support whatever government services we decide to have. Whether a tax bill makes the system more or less fair is at least as important as deciding how it affects economic efficiency or fiscal policy.

Table 4 shows the changes in *after-tax* income that have occurred in the United States over the past decade and the impact of the Bush tax plan taken in its entirety. Over the past decade, those in the

Table 4
Gains In After-Tax Income, 1989-1998

<i>Period</i>	Groups of Tax Filers <i>Percent Change in After-Tax Income</i>			
	Top 1 Percent	95th-99th Percent	90th-95th Percent	0 to 90 th Percent
1989-1993	– 12.2	– 1.0	– 3.3	– 3.3
1993-1998	+60.0	+18.9	+13.6	+8.8
1989-1998	+40.4	+17.8	+9.8	+5.2

Source: Internal Revenue Service, as reported by Isaac Shapiro, "The Latest IRS Data on After-tax Income Trends," Center on Budget and Policy Priorities, February 28, 2001; <http://www.cbpp.org/2-26-01tax.htm> and Robert

Greenstein, "How Would Families at Different Income Levels Benefit from the Bush Tax Cut?" Center on Budget and Policy Priorities, February 6, 2001; <http://www.cbpp.org/2-6-01tax3.htm>.

very top of the income distribution have enjoyed the largest percentage and absolute increases in after-tax income. All of the increase has occurred since 1993, and it has been dramatic—a 60 percent jump in after-tax income for the top 1 percent, double digit increases for the rest of the top decile and more healthy, single-digit increases on the average for the rest. *It is legitimate to enquire whether, in the face of such a striking swing in the income distribution now is the time to enact a tax plan that provides tax cuts to the top 1 percent of the distribution averaging about \$40,000—more than the annual income of half of all U.S. households in 1999.*

The proposed rate reductions apply only to personal income taxes. But for an estimated 74 percent of families who pay income or payroll taxes, payroll taxes exceed personal income taxes. Table 5 shows the share of income taxes as a proportion of all taxes by income class. This table makes clear

Table 5
Income Taxes, as a Share of Total Taxes

<i>Income Percentile</i>	Income Taxes as Percent of Total Taxes
Bottom QUINTILE (0-20)	[Negative]
Second QUINTILE (21-40)	18.6
Third QUINTILE (41-60)	33.5
Fourth QUINTILE (61-80)	38.5
Next 10 percent (81-90)	44.7
Next 5 percent (91-95)	49.4
Next 4 percent (95-99)	58.0
Top 1 percent	65.7

Source: Congressional Budget Office, "Estimates of Federal Tax Liabilities for Individuals and Families by Income Category and Family Type for 1995 and 1999," May 1998;
<http://www.cbo.gov/showdoc.dfm?index=527&sequence=0&from=1.htm>

that a cut in income taxes is bound to exacerbate income inequality unless cuts for moderate income families are proportionately larger than those for upper income families and unless some way is found to provide relief to low-income families who pay taxes other than income taxes.

Is there a better way?

Mr. Chairman, this committee is a leading arena in the fight to reform the personal income tax. You and others have not yet succeeded in that fight. On the contrary, in the fifteen years since the Tax Reform Act of 1986, tax legislation has repeatedly added complexity and increased economic distortions. The record has included some bright spots, most notably the liberalization and extension of the earned income tax credit to provide relief to low-earners who may pay little positive personal income tax but face payroll taxes from the first dollar they earn. This change, together with other legislation and a tight labor market, has helped make work pay, contributing to a massive increase in labor supply among low earners—especially single women.

A major reason why tax reform is so difficult is that it, first and foremost, redistributes taxes. Tax reform may promise eventual improvements in economic efficiency and higher incomes. But as far as tomorrow's paycheck or next year's tax return is concerned, such gains are just promises. At the instant rules change, some people will pay more tax and some will pay less, and the gains will just about equal the losses. Rate cuts could alleviate the sting caused by repeal of provisions that help particular taxpayers and help the prospects for reform. The 1986 reform worked because it cut rates and those rate cuts were possible because taxes were shifted from individuals, who vote, to corporations, which don't.

Either the Administration's proposal or the smaller, Democratic alternative offers a sufficient cushion for a number of important reforms. But such reforms are not under discussion. This hearing is not the time to go into detail on the form that such legislation might take. But a short list would include a greatly increased standard deduction (with no above-the-line deductions) so that fewer more people could fill out the one-page EZ return or form 1040A, an end to phase-outs of personal exemptions and itemized deductions so that rate schedules mean what they say, replacement of the welter of tax sheltered savings vehicles by a single plan with simplified rules, replacement of the truly comical complexity of capital gains rates and holding periods with a single inclusion fraction for long-term gains, reform of both the individual and corporate minimum taxes, and an aggressive campaign to introduce a return-free income tax system such as other countries now use.

But it is the place of today's witnesses to remind members of this committee that today's budget surplus can achieve purposes other than simply returning the people's money to them. It can also be used to pay off the people's public debt. It can be used to make sure that the people's public services are adequate. It can be used to simplify the people's tax system so that they can understand that system and to reduce tax-induced distortions that retard investment, labor supply, and overall growth.